Final Report on Family Financial Arrangements: Guarantees November 2006

The Law Reform Commission of Saskatchewan

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Introduction

Family members often help one another meet financial needs. Children often turn to their parents for assistance and most parents regard it as appropriate to help. The assistance may take the form of a gift or loan but often takes the form of guarantee of a loan from a financial institution. This places no immediate financial burden on the guarantor but if the borrower defaults on the loan the guarantor will be responsible for paying off the loan.

Arrangements such as these are common, a normal part of family life. However, they can go badly wrong. As the Canadian Centre for Elder Law Studies (CCELS) observed in a recent study:

> Helping out younger family members is a priority for many older adults. Sometimes, however, that help can result in unintended and untenable financial hardship for older adults and strain family relationships to the breaking point, even where all parties have the best of intentions.[1]

The informality that often surrounds financial arrangements within families can lead to misunderstandings and conflicts even if the beneficiary of a loan or guarantee intends to repay the loan if other financial obligations may come to seem more pressing, or the parties had different expectations about the transaction. In some cases, the arrangement may be abusive and exploitative from the outset. A family member may take advantage of good will of a relative, exercising undue influence to procure a guarantee of loan that he or she never intends to repay. As CCELS notes:

> The older adult who gives a family guarantee is in an extremely vulnerable position. Guarantees are often complex arrangements and there is a very real chance that the guarantor may not appreciate the nature of the risks being assumed or the extent of his or her obligations under the guarantee.

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[1] Canadian Centre for Elder Law Studies, *Consultation Paper on Financial Arrangements between Older Adults and Family Members: Loans and Guarantees* (Vancouver: British Columbia Law Institute, September 2003) at 1, online: <http://www.ccels.ca/publications/CP_Financial_Arrangements.pdf> ["CCELS Consultation Paper"]. See also Canadian Centre for Elder Law Studies, *Report: Financial Arrangements Between Older Adults and Family Members: Loans and Guarantees* (Vancouver: British Columbia Law Institute, October 2004), online: <http://www.ccels.ca/publications/Financial_Arrangements_Rep.pdf> ["CCELS Report"]. CCELS is a British Columbia-based organization. It studied loans and guarantees in the British Columbia context. The Commission acknowledges its debt to the work done in this area by CCELS.

The National Committee for Prevention of Elder Abuse found that the perpetrators of financial abuse[2] are usually:

> Family members, including sons, daughters, grandchildren, or spouses. They may:
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> - Have substance abuse, gambling, or financial problems.
> - Stand to inherit and feel justified in taking what they believe is "almost" or "rightfully" theirs.
> - Fear that their older family member will get sick and use up their savings, depriving the abuser of an inheritance.
> - Have had a negative relationship with the older person and feel a sense of "entitlement".
> - Have negative feelings toward siblings or other family members whom they want to prevent from acquiring or inheriting the older person's assets.[3]

It is difficult to determine just how frequently intra-family guarantees become a serious problem. However, financial abuse in various forms is the type of elder abuse most often reported.[4] Financial abuse is often not reported. Seniors may not realize that a legal remedy is available or know who to report the problem to, or be embarrassed to admit having made a mistake.[5] Parents are reluctant to take their children to court and may not wish to jeopardize family relationships.[6]

For these reasons, legal solutions to problems created by abuse of financial arrangements such as these are difficult to devise. Effective solutions must go beyond law reform. Education of

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2 "Financial abuse is the misuse of an older adult's money or belongings by a relative or a person in a position of trust": "Financial Abuse of Older Adults", online: Public Health Agency of Canada, National Clearinghouse on Family Violence, <http://www.phac-aspc.gc.ca/ncfv-cnivf/familyviolence/html/ agefinancialab_e.html> ["PHAC Financial Abuse"]. Thus, intra-family financial arrangements can be regarded as abusive even if not deliberately exploitative.

3 "Financial Abuse", online: National Committee for Prevention of Elder Abuse, <http://www.preventelderabuse.org/elderabuse/fin_abuse.html>. See also A.P. Blunt, "Financial Exploitation: The Best Kept Secret of Elder Abuse" (1996) *Aging* 367 (Spring 1996) 62.

4 J. Wahl & S. Purdy, *Elder Abuse: The Hidden Crime* (Centre for the Elderly and Community Legal Education Ontario: Toronto, 1991).

5 Marie Beaulieu & Charmaine Spencer, *Older Adults' Personal Relationships and the Law in Canada: Legal, Psycho-social and Ethical Aspects* (Law Commission of Canada, 1999).

6 L.G. Forer, *Unequal Protection: Women, Children and the Elderly in Court* (New York: W.W. Norton & Co., 1991). See, generally on the problem of dealing with financial abuse, Donald Poirier & Norma Poirier, *Why is it so difficult to combat elder abuse and, in particular, financial exploitation of the elderly?* (Law Commission of Canada, 1999).

the elderly and the helping professions and creation of a network of support services to assist elderly citizens are clearly required to address the growing problem of financial abuse.[7]

However, abuse of guarantees may be easier to address because a third party, the lending institution, is involved in addition to the borrower and guarantor. While it may not be possible to prevent abuse if the guarantor refuses to take advice, full disclosure of information by the lender is an important safeguard that will prevent abuse in many cases.

Financial institutions themselves are becoming more aware of the problem of financial abuse of seniors. Many will advise against a hasty guarantee. This report recommends adopting legal disclosure requirements as an additional consumer protection measure.

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[7] For a general discussion of the problem of financial abuse and community-based responses, see PHAC Financial Abuse, *supra* note 2.

Legal Background

It is not uncommon for a family member to be asked to guarantee a loan for another family member. Often, the assistance is sought when the borrower has been told by a financial institution that a guarantor is required as a condition for the loan because the borrower has insufficient security to satisfy the lender. Unlike intra-family loans, guarantees are almost always in writing, in the form required by the financial institution making the loan. If the borrower defaults on loan payments, the lender can demand payment from the guarantor.[8]

Intra-family guarantees are most apt to cause difficulty if the guarantor does not understand the full implications of the guarantee. It has been suggested that:

> People often co-sign or guarantee a loan for a friend or relative without knowing what can happen. If they knew, they might not co-sign or guarantee the loan…
>
> Sometimes it's necessary or helpful to co-sign or guarantee a loan. It may be a sound business deal, or it may help a family member. But before you agree to put yourself at risk, look at the situation carefully. Ask questions like:
>
> - Why does the lender require a co-signer or guarantor?
> - How high is the risk that the borrower will have trouble and you'll have to pay the loan?
> - What will happen if you don't sign?
> - Most importantly, can you afford to pay off the loan if the borrower can't?
>
> If you're not sure about your responsibility, or about anything else in the loan contract, get advice from a lawyer.[9]

Financial institutions are becoming more aware of the problem of financial abuse of seniors. A family member may be warned of the risks in giving the guarantee. In many financial institutions it is standard practice to require the guarantor to sign it in the presence of a notary who is expected to give some explanation of its effect. But these practices are not uniform. The guarantor cannot always rely on the financial institution to provide full information about the

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[8] Alternatively, a family member may co-sign a loan with another family member. In this case, both family members are principal debtors. In the case of a guarantee, the lender must demand payment from the borrower before seeking payment from the guarantor. The lender may demand payment from either co-signer without demanding payment from the other. Because most people probably understand that co-signing a loan makes them liable to pay it, co-signing is less problematic than guaranteeing. The recommendation discussed below in regard to guarantees could, however, be adapted to extend to co-signing.

[9] *Co-signing or Guaranteeing a Loan*, online: Canadian Bar Association, <http://www.cba.org/BC/public_media/credit/248.aspx>.

guarantee and the law generally does not require the lender to disclose information about the guarantee except in response to specific questions posed by the guarantor.[10]

The law presumes that guarantors understand this risk, but as CCELS observes:

> The presumption that risks are understood may not be accurate where the guarantor is a family member motivated by loyalty and the desire to help. Family member guarantors may have little experience with lending practices, and may not understand the reasons why guarantees are necessary... A family guarantor may feel inhibited about asking questions, not wanting to suggest a lack of confidence in the ability of the borrower to make repayments or otherwise "rock the boat".[11]

If the guarantor has misunderstood the obligations he or she has undertaken, there are some limited circumstances in which the court may void the guarantee.

1. Mistake

The guarantor may allege that he or she was mistaken about the nature and terms of the agreement.[12] If successful, this plea will overturn the agreement and require the borrower to return the money received. The courts rarely find that a mistake of this sort has occurred when, as in the case of guarantees, the agreement is in writing.[13] The rule also applies to intra-family loans but the courts are reluctant to make a finding of mistake even if the agreement is not in writing. In the absence of undue influence or misrepresentation, this plea is most likely to succeed if the person pleading it can be shown to be mentally incompetent.[14] For that reason, mistake may be an important consideration in cases in which a family member has taken advantage of the declining mental capacity of an elderly person.

2. Misrepresentation

An agreement may be overturned on the grounds that one party has misrepresented the terms of the agreement to the other. In the case of a guarantee, the guarantor would have to show that the financial institution misrepresented the guarantee. In the case of an intra-family loan, the loan could be overturned if the borrower misrepresented its nature or terms.

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10 David. G.M. Marks & Gabriel S. Moss, *Rowlatt on the Law of Principal and Surety*, 4th ed. (London: Sweet & Maxwell, 1982). There is an exception if any "unnatural circumstances" exist but these do not include, for example, the reasons why the lender required the borrower to secure a guarantor.

11 CCELS Consultation Paper, *supra* note 1 at 3.

12 In law, a mistake of this kind is referred to as *non est factum* (literally "not his deed").

13 See *Duhaime's Canadian Contract Law*, 2004.

14 *Beaulieu v. National Bank of Canada* (1984), 55 N.B.R. (2d) 154 (C.A.).

In the absence of undue influence or mistake, the misrepresentation must generally be fraudulent.[15] It has been held that for a finding of fraudulent misrepresentation to succeed, it must be shown:

> (1) that the representations complained of were made by the wrongdoer to the victim (before the contract); (2) that these representations were false in fact; (3) that the wrongdoer, when he made them, either knew that they were false or made them recklessly without knowing whether they were false or true; and (4) that the victim was thereby induced to enter into the contract in question.[16]

This is often a difficult test to meet in practice.

3. Unconscionability

An agreement may be overturned as unconscionable if one of the parties took unfair advantage of the frailties of the other to induce him or her to enter the agreement. A lending institution might be held to have taken advantage of a guarantor. If the unconscionable party is a borrower who induces the guarantor to provide the guarantee, the guarantee can be voided only if the lender knew of the unconscionability. In the context of intra-family loans, the family member who borrowed from the victim might be accused of unconscionability.

Although unconscionability is a doctrine originally developed by the courts, it has been partially codified in Saskatchewan. *The Unconscionable Transactions Relief Act*[17] provides:

> **3** Notwithstanding the provisions of any other Act, where, in respect of money lent, the court finds that, having regard to the risk and to all the circumstances at the time the loan was made, the cost of the loan is excessive or that the transaction is harsh or unconscionable the court may:
>
> > (a) re-open the transaction and take an account between the creditor and the debtor and relieve the debtor from payment of any sum in excess of the sum adjudged by the court to be fairly due in respect of the principal and the cost of the loan...

Note that the Act deals only with unconscionability on the part of lenders, not borrowers who induce others to loan them money. Thus, it has little application to intra-family loans. However, the Act defines "debtor" to include a guarantor. Thus it does provide protection for guarantors.

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[15] Fraudulent misrepresentation may also be a criminal offence.

[16] G.H.L. Fridman, *The Law of Contract in Canada*, 3d ed. (Scarborough, Ont.: Carswell, 1994).

[17] R.S.S. 1978, c. U-1.

To find unconscionability, the court must be convinced that the agreement was unfair and that the parties were unequal because of "ignorance, distress or incapacity of the weaker party".[18] As CCELS notes:

> [T]he pith of the doctrine is actual *exploitation* and the inequality of the weaker party must be known to and exploited for advantage by the stronger. Circumstances indicating exploitation may include excessive cost; additional security (as opposed to a fresh advance); cursory or perfunctory documentation and/or application process; irregular procedure; inadequate disclosure regarding the nature of the transaction and its risks; lack of fair consideration.[19]

The doctrine of unconscionability is obviously useful in cases of financial abuse. But, as the Centre observes, to the extent that it involves the motives of the party charged with unconscionability, it may not always be available to overturn onerous contracts. It has been held not to apply to a contract that appeared unfair on its face when the motive was nonetheless a "genuine desire to assist a relative, without personal monetary gain".[20]

4. Undue Influence

Like unconscionability, undue influence involves one person taking advantage of a position of power over another person. However, the focus in this case is on the relationship between the parties and the effect it has on the judgment of the wronged party rather than on deliberate exploitation by the wrong-doer. A person acting under undue influence is deemed not to be acting voluntarily. An agreement induced by undue influence will be overturned if it is unfair.

The law presumes undue influence in certain relationships. Thus, for example, a parent is presumed to have influence over a minor child. Other relationships are not presumed to give rise to undue influence but are suspect and may be found to involve undue influence on the facts of the individual case. This includes relationships between husbands and wives,[21] and between elderly persons and their adult children.[22]

Closely related to undue influence, but technically distinct, are situations in which a fiduciary takes advantage of his or her position. A guardian is a fiduciary of a ward. More generally, financial dependency may create a fiduciary relationship.

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[18] *Murphy v. Murphy* (1995), 18 R.F.L. (4th) 107 (Ont. Ct. (Gen. Div.)).

[19] CCELS Consultation Paper, *supra* note 1 at 16.

[20] *Ibid.*, citing *CIBC v. Ohlson* (1996), 180 A.R. 248 (Q.B.).

[21] *Bank of Montreal v. Duguid* (2000), 47 O.R. (3d) 737 (C.A.).

[22] *Avon Finance Co. v. Bridger*, [1985] 2 All E.R. 281 at 288.

Reforming the Law

1. Disclosure requirements

The legal remedies discussed above provide limited but significant protection for elderly family members when intra-family guarantees are made, but the more pressing need is to prevent financial abuse in the first place. The guarantee contract between the guarantor and the lender provides an intervention point at which the full legal effect and possible financial hazards of the guarantee can be brought to the guarantor's attention. The principal inadequacy in the existing law is the limited disclosure lenders are required to give to guarantors.

It should be stressed that disclosure legislation is not recommended here to correct abuses by financial institutions. As noted above, many institutions are increasingly interested in protecting senior citizens who are their clients from abuse. Rather, uniform and effective disclosure requirements will give legal authority to the practice adopted by concerned institutions and ensure that all family members who are asked to give guarantees receive the information required to make an informed decision.

CCELS has developed enhanced disclosure requirements for intra-family guarantees.[23] The Commission recommends that these disclosure requirements should be adopted in Saskatchewan.

Another protection considered by the Commission is independent legal advice for guarantors. There is no doubt that this would help prevent abuse. The lawyer could make sure that the guarantor understands the consequences of the guarantee, explain the disclosure statement, and discuss the risk of the guarantee with the guarantor. However, many of the loans to which the advice requirement would apply are relatively small consumer loans. Independent legal advice would add significantly to the cost of borrowing.

Because financial institutions are aware of the problems that can arise from intra family guarantees, it is in their interests to explain the consequences of guarantees to the parties to loans. Once again, it is important to note that the problem is not financial institutions. The disclosure recommendation is not made because lenders deliberately withhold information but to ensure that the information they provide is uniform and complete. Thus, the context is different than those in which independent advice is mandated to prevent conflicts of interest and undue influence. If disclosure is made by the financial institution using the recommended disclosure form, there is little advantage in requiring independent legal advice. The additional protection it might provide is outweighed by the cost.

It is worth noting that several financial institutions contacted by the Commission routinely require notarized signatures on guarantees. Financial institutions believe this gives them some protection in the event that a guarantor alleges that he or she misunderstood the guarantee. The

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[23] CCELS Report, *supra* note 1 at 29.

visit to the notary likely does help to focus the guarantor's mind on the seriousness of the guarantee. Notaries will usually explain the guarantee and ask the guarantor if he or she understands the document being signed. Although these practices are not uniform they amount to an inexpensive form of very basic legal oversight. They are not sufficient protections, in the Commission's opinion, to justify codifying in law. However, they are good practice for financial institutions.

Recommendations

1. Disclosure by commercial lender

A commercial lender must deliver to the guarantor, before completing a family guarantee, a statement, disclosing the following:

(a) whether the guarantee includes any prior loans to the borrower and, if so, the amount owing under the prior loans,

(b) whether the guarantee covers any future extensions of credit and, if so, whether they are limited in time or amount,

(c) the maximum amount for which the guarantor may become liable under the guarantee or, if the guarantor's liability is unlimited, a statement to that effect,

(d) the right of the guarantor to cancel the guarantee, and

(e) a statement in the form set out in the Schedule.

2. Other information in disclosure form

The disclosure form required by the legislation should be educative, setting out information about the legal effect of a guarantee:

Schedule

Important Information about Guarantees

A guarantee is a binding legal document. It imposes a serious liability. It is not a mere formality. Sign it only if you wish to be bound. If the borrower fails to repay what is owed, you, as the guarantor of the debt, become responsible to pay. If you fail to pay, your assets and income may become liable to seizure to satisfy the debt.

Make sure you understand the terms of the guarantee. It may cover more than the amount of the loan made or credit extended at the time the guarantee is given.

Depending on how the guarantee is worded it may make you legally responsible to pay:

- old debts of the borrower owing to the same lender, or
- future loans made or credit extended by the lender to the borrower.

If you are in any doubt, ask the lender to explain carefully the nature and extent of your legal responsibilities under the guarantee.

The law gives you a "cooling off" period of 10 days in which you may cancel the

guarantee by giving a notice to the lender. Make sure you understand your right to cancel and how notice must be given to the lender.

3. Cooling off period

The legislation should also give the prospective guarantor a 10-day "cooling off period" to consider the effect of the guarantee.